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SUBJECT: Securities Exchanges, Clearing and Settlement:
Alliances Made and Broken; Poker or Chess?
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- ¶1. (SBU) Introduction: The European world of clearing and settlement is not as boring as these dreary back-office chores imply. Intense rivalry in the market place has become even more so - spreading beyond the continent, across the channel and across the Atlantic. Deutsche Borse lost its bid for the London Stock Exchange three years ago and is ending its joint venture with the Chicago Board of Trade (CBOT) only to find the French-based Euronext team striking up alliances with the British and the CBOT.
- ¶2. (SBU) Policy wonks have also been busy. The European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) issued a consultation paper proposing standards for clearing and settlement. Among the interesting features of these proposals is the notion that clearing and settlement systems should be open to investment firms, but such firms from third countries could be denied access if their home market supervision was not considered "adequate." The European Parliament adopted a report to hem in competition between custodians and clearing and settlement organizations. In April the Giovannini Group presented a critical pathway for liberalization of Europe's clearing and settlement structure. Lots of good ideas and intentions.
- ¶3. (SBU) Enter the European Commission. . This fall the Commission is scheduled to release a second communication and, depending on reactions, might issue draft legislative proposals in December. To date, Commission officials assert that they are content to let the market sort itself out before taking legislative action. Observed one specialist, market pressures are generating solutions that the Commission could never legislate - so best leave the sector alone.
- ¶4. (SBU) The rough and tumble world of clearing and settlement is more like poker than chess - bluffs, calls and raising the stakes. The Commission, congenitally condemned to initiate but not enact legislation, must confine its game to chess. End Summary.

Setting the Scene: The Players and the Pot

- ¶5. (SBU) The European players in the clearing and settlement game are very different from those in the United States. Herein lie a strength and a weakness. The strength is that the largest European players are part of an "exchange complex," that combines clearing and settlement activities with cash listing and trading (equities) (the so-called "vertical silo" approach) and derivatives trading. This allows revenues to be generated from different business lines generally resulting in resilience in the bottom line when one business line experiences weakness, e.g. lower equities trading as is the case at present.
- ¶6. (SBU) The largest of these complexes in Europe are the Euronext group and Deutsche Borse. Smaller, but similarly structured complexes, exist in Italy, Spain and Sweden. According to the MSMOW study published in June 2003, Deutsche Borse received 15% of its revenues from cash listing and trading, 23% from derivatives trading and clearing, 43% from clearing and settlement, and 19% from information products and systems. Euronext was similarly diversified: 26% from cash listing and trading, 34% from derivatives trading, 20% from clearing and settlement, and 17% from information products. Why is this interesting? One German expert explained that since many of its activities are similar, investing one time in software development can generate uses across its product line; increasing the load on those systems drives down marginal costs, increasing profitability.

17. (SBU) Compare this diversity with that of the London Stock Exchange, New York Stock Exchange and Nasdaq, all with the bulk of their revenues coming from cash listing and trading (LSE 55%; NYSE, 74%, Nasdaq 71%). This "horizontal" approach allows investors to move from different systems for each aspect of securities execution, i.e. trading, clearing and settling. As these exchanges are heavily dependent on one or two business lines, in present market conditions, lower listing and trading activities mean a lower total bottom line.

18. (SBU) The weakness in Europe is that there is no one institution that clears and settles - implying heavy investments by the clearing and settlement industry and potential risks to investors. In the US the Depository Trust Clearing Corporation clears and settles all equity securities in the US. The Options Clearing Corporation does so for equity options. Futures are somewhat different, being able to be cleared and settled in the system where they are traded.

19. (SBU) What is the competition in Europe about? The MSMOW study estimates that European exchange complexes took in revenues of euro 5.2 billion in 2002. Profit margins were roughly 26%. Worth a good scuffle for a part of that pie.

110. (SBU) Competition, however, should be viewed on a broader scale, that is, by considering the larger pot of where the investor "spends" money in capital markets transactions in Europe. The MSMOW study estimates that total to be euro 40 billion. Of that amount, exchanges and centralized depositories (institutions holding securities that enables securities transactions to be processed by book entries) took in euro 3.5 billion, custodians (entities that safe keep securities for customers) euro 4.5 billion, data system providers 2.5 billion, and a hefty euro 29.5 billion went to commissions and spreads. Now that is a value chain worthy of an all out fight - exchanges want to cut out the middle man, custodians want to restrain exchanges, and middle men want to keep business in house (internalize transactions) or at least away from an order book open to all on an electronic exchange (hear the mouse click away their revenues?).

Action: Market Players

111. (SBU) Three years ago Deutsche Borse was going for the "golden ring." A merger with the London Stock Exchange was rumored in the press and its "vertical" processing of trading, clearing and settlement (straight through processing) was envied, copied, and attacked as anticompetitive. Deutsche Borse struck up a joint venture in the derivatives market with the CBOT in the United States. Life seemed beautiful; but it still was life. The merger didn't happen, other exchange complexes have developed or are planning their own straight through processing systems, Commission competition authorities have opened an investigation, and the joint venture with the CBOT will be dissolved at the end of 2003.

112. (SBU) Instead of Deutsche Borse domination, there seems to have been a shift to what one analyst terms the "ABW Strategy," or an "anybody but Werner strategy," referring to the head of Deutsche Borse who has been referred to as "visionary," "opinionated," or "abrasive." Highlights include:

- Merger of CrestCo with Euroclear (the settlement operations for the London Stock Exchange and Euronext, respectively);
- Proposed merger of the London Clearing House and Clearnet (the clearing operations for the LSE and Euronex respectively)
- The CBOT replacing its trading platform under license from Eurex, the Deutsche Borse derivatives operation, with new contract with LIFFE Connect, designed and built by Euronext.liffe (over a year ago Euronext had purchased the London International Financial Futures Exchange)
- Nasdaq Europe has announced it will close down its exchange in Brussels at the beginning of 2004 and will close Nasdaq Germany by the end of August.

113. (SBU) Deutsche Borse, however, has managed a few surprises of its own. DB has introduced a system to help brokers/dealers to internalize transactions (if they can't beat'em, join'em - or at least made some money out of the deal) and has announced that it will:

- seek to establish its own licensed exchange in the US to compete in the derivatives market;
- open its system to investors from other systems, forsaking the "silo approach" if others (read Euronext) do the same;
- implement an automated daytime bridge between Clearstream International (its settlement bank) and

- Euroclear Bank to allow same-day bridge transactions; attract Dutch brokers and dealers displeased with their Euronext association (fees went up this year for the first time) (the LSE also seeking to pick up some of the business from the disgruntled Dutch traders).

Kinda leaves you breathless, waiting for the next move.

Action: Policy Wonks

114. (SBU) European policy officials also have ventured into the clearing and settlement terrain.

- The European Commission is collecting comments on its May 2002 Communication on clearing and settlement and is expected to publish another communication in September;
- The European Commission's November 2002 proposal for the revision of the Investment Services Directive would require member states to ensure investment firms from other member states have access to central counter party and clearing and settlement systems in their territory and that stock exchanges allow participants to designate the system for the settlement of transactions;
- European Parliament adopted a report in December 2002 on clearing and settlement proposing that core settlement services should be managed as a user-owned service governed by rule of a non-profit entity and that central securities depositories perform only settlement services and not "value added" services;
- European Commission competition authorities opened an infringement proceeding in March against Deutsche Borse's Clearstream Banking AG for refusing Euroclear Bank's access to the settlement platform for more than two years and for charging higher transaction prices to Euroclear than to other national central securities depositories outside Germany.
- Giovaninni Group's Second Report on Clearing and Settlement issued in April presented a program and schedule for removing barriers to clearing and settlement within the EU.
- ESCB/CESR's Consultative Report on Standards for Securities and Clearing Settlements in the European Union issued at the end of July proposed standards to sustain integration in the EU by having one single set of standards for a regulatory framework.

The ESCB/CESR work deserves special mention.

ESCB/CESR: Softer than a Law but Harder than a Recommendation

115. (SBU) The ESCB/CESR Consultative Paper was prepared by a ESCB-CESR Working Group comprised of representatives of 15 national banks of the EU and representatives of CESR. The Working Group has proposed 19 standards for clearing and settlement systems covering such topics as legal framework, settlement cycles, central counter parties, central securities depositories, delivery versus payment, risk controls, operational reliability, governance, access, transparency, and regulation, supervision and oversight, and risks in cross-system links. Comments on the paper are due by October 31. A public hearing will be held on October 2 in Paris.

116. (SBU) The paper reflects the Giovaninni Group's Second Report, the Group of Thirty's 20 recommendations on clearing and settlement systems released in January, and the Recommendations for Securities and Settlements Systems issued by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) in November 2001.

117. (SBU) The standards aim to provide a consistent basis for regulation, supervision and oversight of securities clearing and settlement systems, enhance the safety, soundness and efficiency of such systems, protect investors, promote competitive EU markets, and avoid systemic risks.

118. (SBU) These standards are unique in several aspects. The first, is that they are "standards." They are not recommendations to take or leave. Neither are they mandatory since they would not have Community law status. Rather, the ECB/CESR Group believes that standards will be of a more binding nature than recommendations and that regulators will implement them on a "best-effort" basis. This has worked for the ECB in its standards for securities settlement systems in credit operations in the ESCB. However, the ESCB/CESR proposed standards on clearing and settlement go well beyond ESCB activities.

119. (SBU) A second interesting feature is the proposal to apply many of the standards to major custodians, including custodian banks, some of which clear and settle in-house rather than going to local clearing and settlement systems. Some of these banks have significant operations and would be

considered "systemically important custodians." The ECB/CESR has proposed four criteria to identify such institutions: (1) magnitude of activities (e.g. 5% of EU market or 25% of a domestic market); (2) number of systems; (3) nature and number of clients; and (4) the possibility of being replaced in the event of failure. Banks that have a large presence in the custodian business in Europe include BNP Paribas and Citigroup.

120. (SBU) Finally, the standards go well beyond the competence of national banks and securities supervisors to cover tax, accounting and other legal issues. To ensure consistent implementation and compliance, the Group notes the importance of cooperation and information exchange among competent authorities. To ensure such cooperation is done in a regular and structured manner, the Group volunteers to take on a monitoring role to organize and co-ordinate assessments of implementation.

Some Observations: Connecting the Dots

121. (SBU) Actions by market participants and policy wonks have been, to some degree, symbiotic. Here are some examples.

- (a) Cross-Border Activities: Increased cross-border activities in clearing and settlement presaged by the Crestco and Euroclear merger or anticipated merger between LCH and Clearnet suggests that standardization of rules not only needed to integrate the EU market, but to ensure that integration at the company level works at the operations level, bringing promised efficiencies to investors while protecting them from increased risks cross-border transactions. Thus, the ESCB/CESR stand have some urgency from a supervisory point of view. It is some time, however. According to a London-based expert not much has changed in the actual operations of Crestco Euroclear, for example, so the continental and UK systems still run separately.
- (b) Access: Deutsche Borse's willingness to open its system to investors that trade on other platforms reflects the pressure from the ISD proposal, the Commission's competition policy investigation, and, to some extent ESCB/CESR standard on access. Access is not to be achieved. The ESCB/CESR standard would require objective and published criteria that permit "fair and open access" still being able to control risk. Access could be denied a clearing and settlement system if it posed risks that could not be effectively controlled. What about access investment firms from other countries? Access could be denied, according to ESCB/CESR if there is a lack of "adequate supervision" and doubts about the enforceability of the legal powers of the service provider in the host country.
- (c) Governance: The ESCB/CESR standard on governance calls for arrangements designed to fulfill public interest requirements and to promote the objectives of owners and users. This reflects, in part, the views in the European Parliament report proposing to require settlement systems be managed as a user-owned non-profit organization. The European Parliament's view is also supported by a group called "Fair and Clear," composed of large custodian banks including such big players as BNP Paribas and Citigroup.
- (d) Value Added Services: The ESCB/CESR proposed stand on risk controls implies that clearing and settlement systems could extend credits, thus competing with banks. The ESCB/CESR proposed standard states that operators of systemically important systems should not run credit but where they extend credit they should fully collateralize such exposures. Should such systems extend credits to support the orderly functioning of the market, they could offer uncollateralized credit but only to institutions with high credit standing. The European Parliament report proposed that settlement systems not be permitted to extend such credits, a view shared by "Fair and Clear." Her concerns coincide: concerns about risks to settlement systems from credit lending and concerns about competition to custodian banks from settlement systems offering services to their clients. A German expert points out it is a false issue, in that settlement systems are like banks anyway. Moreover, investment firms enjoy the competition afforded by several players in the settlement/custodian business, keeping costs lower and service better than otherwise might be the case.

Where will Competition Drive the Market?

122. (SBU) Allowing the market to find "solutions" to efficient trading, clearing and settlement systems sounds nice. But what does it mean? Where will the market take the trading and post-trading infrastructure? Not being experts ourselves, we listen to what our betters have to

say.

123. (SBU) The MSMOW study presents there views on how several key areas may develop:

- (1) Silo versus horizontal approach: The vertical "silo" structure of exchange complexes that offer clearing and settling and straight through proces been criticized as anti-competitive. A horizontal allows investors access to the trading, or cleari settling systems. The study suggests that this d burn out as market participants and regulators lo expensive costs and adopt pragmatic solutions. V structures will become "interoperable" over time exchange complexes will be able to fulfill their providing market infrastructure and making a prof provided they continue to deliver lower all-in tr costs. So far, this seems to be the trend.
- (2) Separation of Depository from Banking Services: Settlement systems will have a tough time competi banks by offering value added services, in the MS view. Settlement banks, while banks, don't offer range of banking services. When the market picks study expect exchanges will stick to their core b
- (3) Centralized clearing systems: The study "stron believes" that centralized clearing will receive from Basle II. Central counter party mechanisms manage risk and reduce systemic risks. Banks wil such mechanisms to reduce risks and corresponding charges. The ESCB/CESR standard on central count goes in the same direction. It states that where benefits of using a central counter party outweig costs, market participants should either use the an existing one or establish one of their own.
- (4) Internalization versus on Exchange Trading: Th suggests that continental exchanges that use elec trading and a central order book for equity tradi continue to capture a large market share - betwee trading. In the UK, where two-thirds of trades a "facilitated" rather than placed directly on an o book, the study expects little change. In its op customers and the size of orders will dictate the exchange trading and internalization in each mark provided regulation doesn't favor one or the othe

Policy: The Wild Card

124. (SBU) The dynamics of the market place are like a game of poker: increasing investment stakes in high tech infrastructure, improving the hand by striking up more alliances or products, and bluffing about the strategy for improved business. Needs a strong constitution. But the winner's take could be considerable.

125. (SBU) Enter the European Commission. To date, the Commission officials assert that they have been content in allowing market forces to drive changes in the clearing and settlement market. Moreover, others are trying to do some spadework to prepare the terrain. The Giovannini Report and now the ESCB/CESR standards point to the need for member states to take action to bring down legal, regulatory and tax barriers. The ESCB/CESR use of "standards" puts more pressure on supervisors to take action. This is still short of legislation. Nonetheless, it could be a not so subtle threat that if the market doesn't move itself, momentum could build for some type of legislative action. Parliament's report favors legislation, as does the "Fair and Clear" group and others, such as the London Stock Exchange, that believe that clearing or clearing and settlement, should be regulated as a public utility.

126. (SBU) The role for specific legislation is not clear. With so many pieces of legislation pending under the Financial Services Action Plan (FSAP) that will have a significant impact on the financial market place (implementation of the prospectuses, market abuse and financial conglomerates directives and the accounting regulation; potential passage of the transparency and investment services directives) the Commission will be forgiven if not blessed, for letting these and related market-driven changes in clearing and settlement systems run their course. Implementing enacted FSAP legislation as well as the ESCB/CESR standards should be a priority before assessing what, if anything needs to be done through Community law.

127. (SBU) Such an approach is not at all certain. The MSMOW study regards regulation as a "wildcard." It observes that "one should never underestimate the unpredictable nature of lawmaking in Brussels or nationally and potential unintended consequences of legislation." Amen to that. While the market is playing poker, the Commission must and

should be thinking chess.

128. (SBU) The report was coordinated with Embassies Berlin and London and USEU Brussels.

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